UniCredit

CEE

Quarterly

Macro Research
Strategy Research
Credit Research

4Q 2017

Bulgaria (Baa2 stable/BB+ positive/BBB- positive)*

Outlook – We decided to keep unchanged our above-consensus real GDP growth forecast for 2017 and 2018, while making some changes in the composition of growth. That said, next year has the potential to be the year when real GDP growth will reach its peak, with private consumption likely to provide most of the fuel for the acceleration in growth. A surge in construction, both real estate and public sector funded infrastructure projects, will become an important growth driver, too. Importantly, growth is set to remain well balanced and will not come at the expense of a deteriorating C/A balance or rapid accumulation of private sector debt. This will create a supportive environment for policymakers to deal with long-term structural challenges, including deteriorating demographic picture, should there be sufficient political will to do so.

Strategy – Bulgarian EUR bonds will remain scarce and supported by strong fundamentals

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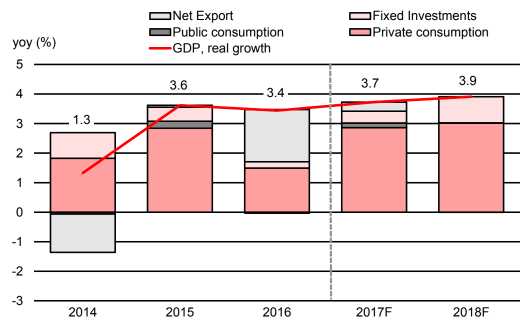
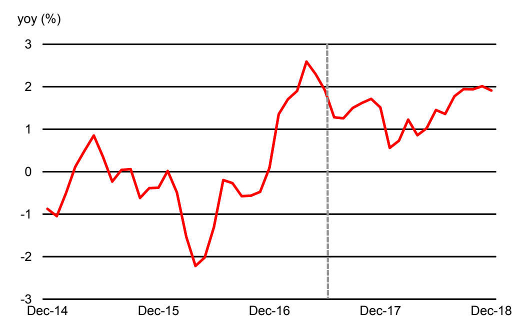
KEY DATES/EVENTS

- 30 Oct: Budget Act introduced in Parliament
- 14 Nov: Flash GDP estimate for 3Q17
- 1 Dec: Credit rating reviews by Fitch and S&P

STRONGER DOMESTIC DEMAND TO LIFT GROWTH



INFLATION TO STABILIZE AT SUBDUED LEVELS



Source: NSI, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2014	2015	2016	2017F	2018F
GDP (EUR bn)	42.8	45.3	47.4	49.9	52.6
Population (mn)	7.2	7.2	7.1	7.1	7.0
GDP per capita (EUR)	5,937	6,330	6,669	7,070	7,484
Real economy, change (%)					
GDP	1.3	3.6	3.4	3.7	3.9
Private Consumption	2.5	3.9	2.1	4.0	4.2
Fixed Investment	3.4	2.7	-4.0	2.0	4.5
Public Consumption	-0.8	2.9	-0.4	2.0	0.1
Exports	3.1	5.7	5.7	6.5	5.8
Imports	5.2	5.4	2.8	6.0	5.8
Monthly wage, nominal (EUR)	420	449	492	538	588
Real wage, change (%)	7.4	7.0	10.3	7.8	7.9
Unemployment rate (%)	11.4	9.1	7.6	6.2	5.3
Fiscal accounts (% of GDP)					
Budget balance	-5.5	-1.6	0	-0.2	-0.7
Primary balance	-4.6	-0.7	0.8	0.6	0
Public debt	26.4	25.6	29.1	25.8	25.4
External accounts					
Current account balance (EUR bn)	0	0	2.6	1.9	1.6
Current account balance/GDP (%)	0.1	0	5.4	3.8	3.0
Extended basic balance/GDP (%)	4.3	8.0	8.2	7.2	6.8
Net FDI (% of GDP)	2.1	5.1	0.7	2.4	2.7
Gross foreign debt (% of GDP)	92.0	75.0	73.1	67.5	62.9
FX reserves (EUR bn)	16.5	20.3	23.9	25.2	27.2
Months of imports, goods & services	6.5	8.0	9.4	8.9	8.8
Inflation/Monetary/FX					
CPI (pavg)	-1.4	-0.1	-0.8	1.7	1.4
CPI (eop)	-0.9	-0.4	0.1	1.5	1.9
Central bank reference rate (eop)	0.02	0.01	0	0	0
USD/FX (eop)	1.61	1.79	1.86	1.63	1.56
EUR/FX (eop)	1.96	1.96	1.96	1.96	1.96
USD/FX (pavg)	1.47	1.76	1.77	1.71	1.60
EUR/FX (pavg)	1.96	1.96	1.96	1.96	1.96
Real effective exchange rate, 2000=100	139.8	136.8	136.0	137.7	138.9
Change (%)	-1.2	-2.1	-0.6	1.3	0.9

Source: Eurostat, NSI, BNB, MoF, UniCredit Research

* Long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

The economy heads for stronger growth next year

The economy is slowly edging closer toward full employment

Growth has been broad based

Unemployment is close to its lowest levels seen since the start of the transition

A wide range of indicators suggests that the economy has continued edging closer toward full employment over the past couple of months. In line with our forecast, real GDP growth posted a small uptick to 3.6% yoy in 2Q17, from 3.5% in 1Q17 and 3.4% on average in 2016. For a third consecutive quarter, all high frequency indicators (including industrial production, retail sales and construction output) rose on a qoq basis (see lhs chart), to reconfirm that growth is not only robust, but also broadly based. The bright picture was complemented by the 11% yoy surge in goods and services exports in 2Q17, which mostly benefitted from the acceleration in global trade and the rebound in GDP growth in the EU, toward which roughly two-thirds of Bulgarian exports are channeled. Against this very positive backdrop, the unemployment rate, at 6.3% in 2Q17, fell to its lowest quarterly level since before the crisis, and the fifth lowest since the currency board introduction 20 years ago (see rhs chart).

We reconfirm our real GDP growth forecast for 2017 and 2018

We keep unchanged our above-consensus real GDP growth forecast for this year (3.7% versus 3.5% Consensus) and next year (3.9% versus 3.3% Consensus). However, there are some important changes in the composition of real GDP growth.

Private consumption is far from losing steam

At this stage, labor shortages look like an isolated phenomenon which only constrains growth in a relatively small number of sectors

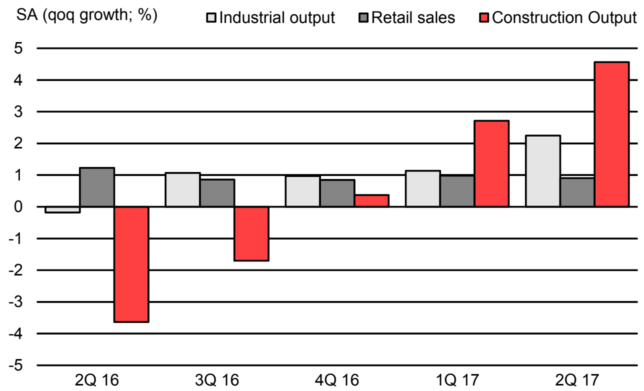
Inflation will be less of a drag on private consumption next year

We now expect private consumption to make a stronger contribution to growth in both 2017 and 2018. Above all, this is attributable to the stronger-than-expected labor market recovery, which is perhaps best illustrated by the doubling in the pace of job creation in the first six months of the year compared with 2016 (1% yoy in 1H17 against 0.5% for the whole of 2016). While the sustainability of the pace of job creation in 1H17 is questionable even in the very short run, the reported results seem to reconfirm our long-held view that labor shortages mostly refer to high-skilled workers. This should mean that labor shortages constrain the pace of economic growth in a relatively small number of sectors, because the dominant part of the economy continues to have mostly low and medium skilled jobs. Our more bullish consumption forecast is also supported by the upwardly revised retail credit growth projection for this and next year, as households' debt servicing capacity has improved and with rising housing prices adding to the stimuli for households to borrow more than we expected three months ago. Finally, the downward revision of our crude oil forecast for 2018 will keep inflation lower, thereby resulting in a tad higher purchasing power of households than we thought. These three factors, when combined, should help propel growth in private consumption to 4.0% in 2017 and 4.2% in 2018, from 3.6% and 3.9%, in our previous forecast.

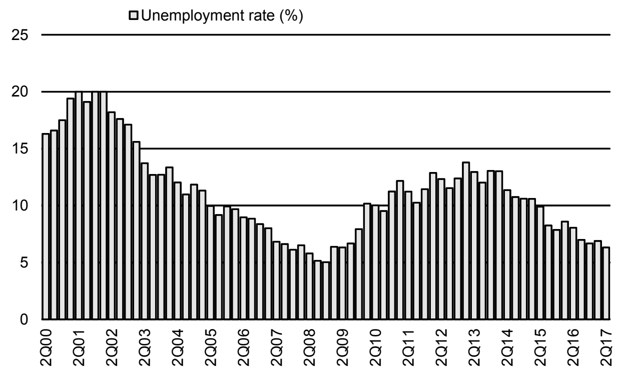
We decided to keep unchanged our projection for export volume growth for 2017 and 2018

At about 6.5%, export volume growth in 2017 should firm slightly from the already strong 5.7% rise in 2016, as the impulse from faster global trade more than offsets the negative impact stemming from the euro's appreciation.

Growth drivers are now moving in sync…



…providing fuel for a stronger labor market recovery



Source: NSI, UniCredit Research

One-off factors will help lift the export performance this year

Export volumes this year are also likely to draw support from the record wheat harvest and another solid rise in tourism revenues. Next year, we foresee a small deceleration of the pace of export expansion to 5.8% due to the forecasted euro appreciation and signs that export growth in Germany is likely to peak in late 2017. However, we regard this as normalization from already high levels, rather than a genuine loss of momentum for two reasons. First, many export-oriented companies continue to invest in expanding production capacity. And second, the goods and services trade balance remains in surplus for a third consecutive year (see left chart), providing clear evidence that, at least in the near term, there is no risk to the country's competitiveness.

Imports are set to rise in response to stronger domestic demand

As growth in private consumption has been upwardly revised in this and, to a lesser extent, next year, we also revised our import projections. We now expect growth in import volumes to accelerate to 6% in 2017 from the 5.6% yoy projected previously, and only marginally less so in 2018, to 5.8% from the 5.5% projected three months ago in our previous publication.

The outlook for fixed investment remains positive

Fixed investment, meanwhile, will continue benefitting from improved corporate profitability, a surge in capital flows channeled toward the CEE region, the sizeable net saving position of the corporate sector in the country, and the still very loose financing conditions. We project investment to expand about 2% this year - a reasonably good number, given the very slow start of EU-funded infrastructure projects from the new planning period.

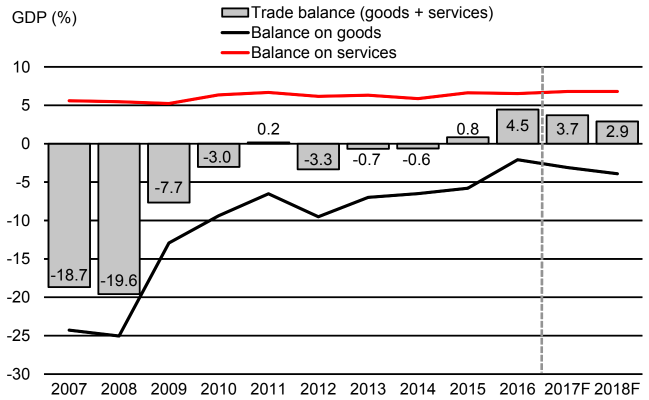
We keep our growth projection for the fixed investment unchanged at 2% in 2017 and 4.5% in 2018

In 2018, the pace of fixed investment growth should accelerate to 4.5%, mostly due to a surge in construction. We expect the latter to remain well supported by the favorable prospects for household incomes and jobs, which, along with rising house prices, will keep residential construction on track for a solid expansion. However, most of the fuel for the acceleration in construction next year will come from the public sector. As we pointed out in June, the boost associated with the implementation of EU funded infrastructure projects from the new planning period has taken more time to materialize than we thought initially. The reasons for this are not quite clear, but, at least in part, seem to reflect the lack of continuity in the work of the agency which administrates road construction projects, and particularly with the numerous appeals at local courts and antitrust authorities of many already awarded contracts when the snap elections were called at the end of 2016. With the new administration now up and running, and most of the appeals resolved by the courts, we expect a large number of the infrastructure projects from the new planning period to get to the shovel-ready stage soon and provide the much anticipated boost to the economy next year.

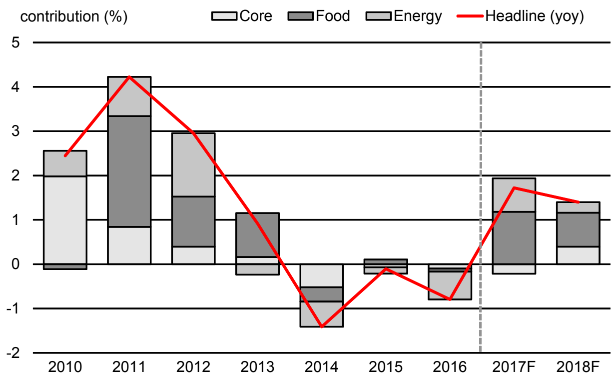
The positive impact from lower crude oil prices next year will more than offset the increased price pressure stemming from our upward revision in private consumption growth

Just as we forecasted in our previous publication three months ago, headline inflation eased markedly during the summer, after peaking in April on the base effect from higher energy prices and the seasonal rise in unprocessed food prices. With oil prices now expected to stay stable in 2018, we forecast somewhat weaker average inflation next year (1.4% against 1.6% previously), while keeping the projection for this year unchanged at 1.7% (see right chart).

We see no material risks for cost competitiveness of the economy



Weak core inflation will anchor the CPI



Source: NSI, BNB, UniCredit Research

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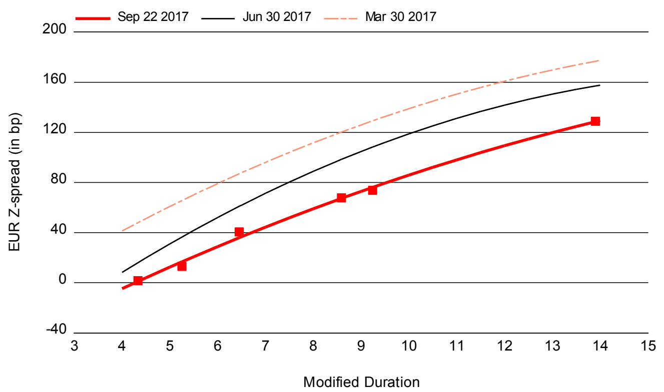
Strategy: solid fundamentals, tight valuation

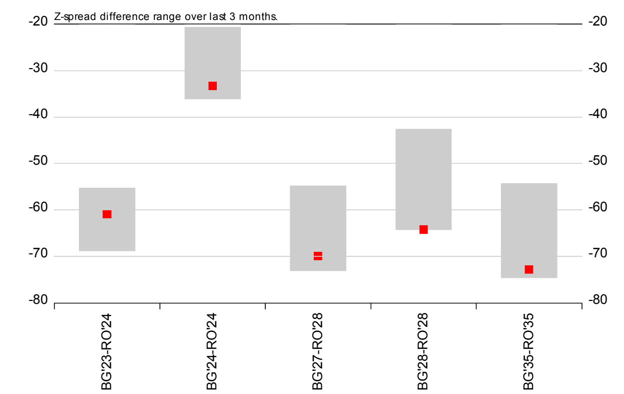
Bulgarian EUR-denominated bonds continued their outstanding performance in 3Q17, with total returns exceeding 4% in the maturities longer than 10Y, and the 2035 bond returning north of 9%. Scarcity of the bonds was made worse with the EUR 950m bond maturity in July, which was not matched with sufficient additional supply in either the domestic or external market. Banks remain awash with liquidity and the limited domestic set of investment alternatives makes the local bid for Eurobonds strong and the liquidity in secondary markets very thin. Demand and supply of bonds are out of balance and will continue to remain so during 2018 when we expect the fiscal primary balance to be near zero, with no external bond issuance and limited domestic issuance.

Bonds could be lifted further if S&P aligns its external rating opinion with that of the other two major agencies and upgrades it to investment grade and, given Bulgaria's external and fiscal metrics, this divergence should be corrected promptly.

EUR Z-spreads shifted downwards across all maturities…



… and bonds outperformed peers over the last quarter



Source: Bloomberg and UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2016	2017F	2018F
Gross financing requirement	**0**	**2.0**	**1.3**
Budget deficit (cash basis)	-0.8	0.5	0.6
Amortization of public debt	0.7	1.5	0.7
Domestic	0.5	0.4	0.5
Bonds	0.5	0.4	0.5
Bills	0	0	0
Loans	0	0	0
External	0.2	1.1	0.2
Bonds and loans	0	1.0	0
IMF/EU/Other IFIs	0.2	0.2	0.2
Financing	**0**	**2.0**	**1.3**
Domestic borrowing	0.3	0.5	1.0
Bonds	0.3	0.5	1.0
Bills	0	0	0
Loans	0	0	0
External borrowing	2.4	0.1	0.1
Bonds	2.3	0	0
IMF/EU/Other IFIs	0.1	0.1	0.1
Privatization/Other	0	0	0
Fiscal reserves change (- =increase)	-2.6	1.5	0.2

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2016	2017F	2018F
Gross financing requirement	**9.2**	**10.7**	**9.5**
C/A deficit	-2.6	-1.9	-1.6
Amortization of medium and long term debt	3.9	4.6	3.5
Government/central bank	0.2	1.1	0.2
Banks	0.5	0.4	0.4
Corporates/Other	3.2	3.1	2.9
Amortization of short-term debt	7.9	8.0	7.6
Financing	**9.2**	**10.7**	**9.5**
FDI (net)	0.3	1.2	1.4
Portfolio equity, net	0.6	-0.4	0.1
Medium and long-term borrowing	5.4	3.2	2.4
Government/central bank	2.4	0.1	0.1
Banks	0.3	0.4	0.5
Corporates/Other	2.8	2.7	1.9
Short-term borrowing	8.0	7.6	7.3
EU structural and cohesion funds	1.0	0.5	0.6
Other	-2.6	-0.1	-0.3
Change in FX reserves (- =increase)	-3.6	-1.3	-2.0
Memoranda:			
Nonresident purchases of LC govt bonds	0	0	0
International bond issuance, net	2.3	-1.0	0

Source: BNB, MoF, UniCredit Research

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